

Endowment Review Report  
St. Paul's School  
April 2004

I have been asked by the Attorney General of the State of New Hampshire to review matters related to St. Paul's School's endowment as part of the settlement reached between the state and the school in February 2004.

I reviewed materials provided by the school to the Division of Charities, and additional material from the school's Business Office and from Professor Jay Light. I reviewed Investment Committee meeting minutes through the most recent meeting of February 25, 2004 and the consultant SCA's reports of the endowment through December 31, 2003. I met with Professor Light and exchanged drafts with him. I met with Investment Committee member Andrew McLane in his office and had an extensive phone conversation with Robert Lindsay. I have talked with others involved in the oversight and management of endowment funds and re-read the latest reports from Harvard and Yale, both institutions that are considered to be on the leading edge of endowment management, albeit on a scale that counts assets in billions of dollars, not millions.

My perspective is drawn from more than 40 years in the investment business, the last 26 years as an investment advisor. I have served as a trustee, member and chair of various investment committees for more than 20 years including at an independent school (Milton Academy, for full disclosure) and on New Hampshire's statewide Community Foundation. In both roles I have dealt with and hired and replaced investment consultants. I subsequently served as board chair of both of these organizations. I am familiar with the range of alternative investments in my role as an investment committee member and through personal investments that I have made.

The report that follows reflects my views. I have attempted to make it as non-technical as reasonable, addressed not solely to the members of the school's Investment Committee but to the full Board that bears the ultimate responsibility for the endowment and the institution as a whole.

I look forward to the conference call planned as a follow-up to our reports.

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Endowment Review

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Introduction

I have been engaged by the Attorney General's office in connection with its review of the school's endowment as part of the settlement reached by the school and the State of New Hampshire in February. Specifically, I was asked to analyze, review, and offer opinions upon matters relating to investment policies, asset allocation models, the Prudent Investor Rule, and other investment issues. I reviewed the material provided to the state by the school, including the current Investment Policy Statement, the annual audits, 990's, reports of SCA, the school's investment consultants, and minutes of Investment Committee meetings. I met with Michelle Chicoine, met or held phone calls with several members of the Investment Committee, and met with Professor Jay Light whom I found to be most cooperative.

In my review and recommendations I have drawn on my experience as an investment advisor and as long-term member of investment committees of two endowment funds.

The recent release of the report of the Governance Advisory Panel to The Nature Conservancy is recommended reading for anyone with an interest in and responsibility for non-profit organizations. The Blue Ribbon Panel concludes that times have changed. Policies and practices must change with them. The following excerpt from that report<sup>1</sup> serves as an appropriate introduction to today's issues.

The Board

"The past years have witnessed a dramatic shift in public expectations regarding the accountability of private organizations and the responsibilities of their governing boards. These developments promise to bring new pressures to bear on non-profit boards to become more informed and more active in overseeing their operations. The panel believes that an essential issue of board governance is insuring that the board serves as an active and objective body for monitoring management activities. Because non-profits receive private donations and public benefits, it is essential that a non-profit board insure that managers use organizational assets for their intended purpose and scrupulously operate in a transparent, lawful and ethical manner."

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<sup>1</sup> Report of The Governance Panel to the Executive Committee and the Board of Governors of The Nature Conservancy March 19, 2004.

### Summary

New Hampshire's Uniform Trustees' Powers Act sets forth the general standards of prudent investment. Fortunately it is a reasonable standard that does not create unrealistic impediments to trustees in fulfilling their fiduciary responsibilities. My conclusion is that St. Paul's' incorporation of unorthodox, non-traditional asset classes (hedge funds and private equity) is, in and of itself, not imprudent in the context of the New Hampshire act. Many, generally larger, endowments have incorporated non-traditional investments in their mix. However, by any standard St. Paul's 70% allocation to hedge funds and private equity is too high. Harvard and Yale report allocations of 25% and 40% respectively at 6/30/03. Moreover, both organizations have substantial, sophisticated staff supporting the investment of their multi-billion dollar endowments.

Treasurer Baker deserves credit for protecting the endowment through the recent bear market. He brings considerable experience in the world of hedge funds and private investments to the school. However, there are serious considerations that concern me. These include the unusual complexity of the endowment, its lack of transparency, a surfeit of statistical data and a shortage of useful information, a proclivity to hedge funds and private equity vehicles over readily marketable alternatives, as well as other asset classes in public or private form, and relatively high costs. The need for cash (\$18 million) to fund the school's annual budget combined with its forward capital commitments to private partnerships (\$54 million), plus capital draws for campus projects from a portfolio that generates no income net of fees is a challenge. Finally, the purely advisory role assigned to the Investment Committee is inappropriate.

### Governance

The Board of Trustees adopted the current Investment Policy Statement at its October 24-26, 2002 meeting. According to the minutes, the Treasurer said, "It is meant as a guide but we need a statement such as this on file." As the principal document covering the management of the school's funds, it should not be treated so casually. I do not believe the policy should grant sole authority over the endowment to the Treasurer or any single trustee, no matter how experienced. That authority properly belongs to the Investment Committee. The school's Policy Statement should be revised accordingly.

The Policy Statement includes the following table:

<u>Asset Class</u>	<u>Minimum Allocation</u>	<u>Target Allocation (01/01/02)</u>	<u>Maximum Allocation</u>
Domestic Equity	15%	20%	80%
Alternative Investments (Energy, Private Equity & Absolute Return Strategies)	10%	70%	75%
Foreign Securities	5%	7%	20%
Fixed Income	0%	0%	20%
Cash	0%	3%	20%

This is a step in the right direction since the previous policy had no such table or guidelines, but it is far too broad. Allocating 70% of the endowment to "alternative investments" is tantamount to no allocation at all since alternatives cover such a broad variety of investment types from hedge funds, which themselves cover the full risk spectrum, to private equity with its own equally broad range, plus real estate, energy, and so on. To be meaningful as a policy these categories should be broken out with appropriate upper and lower limits. SCA's reports do provide the appropriate sub-categories. The policy should establish a maximum allocation to non-marketable investments. The minimum/maximum allocation ranges in the existing policy are so broad as to be meaningless, e.g., domestic equity, 15-80%, alternative investments, 10-75%, fixed income, 0-20%. A narrowing of all of these ranges would provide the trustees with at least some sense of responsibility for and understanding of what asset allocation is all about. Both the Policy Statement and the Target Asset Mix should be reviewed by the Investment Committee, adjusted as needed, and ratified by the trustees each year. Evidence that the policy was indeed adopted "for the file" is found in the subsequent \$6 million commitment to CT Fixed Income even though the target allocation to fixed income is zero. Finally, there is no reference in the policy or in the minutes of Investment Committee meetings to any process of rebalancing under which the asset mix is adjusted reflecting long term valuation and market dynamics.



## Areas of Concern:

### 1. Complexity

The complex structure of the school's endowment creates a management challenge, not only for the school's staff to provide the necessary support, but for the Investment Committee. It is all very well to say that Harvard, Yale and Princeton pursue similarly diversified endowment programs, but they have substantial, sophisticated in-house investment offices. St. Paul's does not. The school must rely on the good offices of the Treasurer who is in turn highly dependent upon SCA, its consultant, to monitor the existing investments and screen potential new managers and opportunities.

Just how complex is the endowment? As of December 31, 2003, SPS endowment assets were divided among seven equity managers, 13 individual hedge funds, two Fund of Funds (which in turn are invested in 37 additional separate hedge funds), and 25 Private Equity Partnerships. That brings the total number of moving parts to 47 not counting the sub-investments in the two Funds of Funds. Individual positions ranged from 1% to 10% of the total endowment. (A 1% position amounts to \$3.2 million.) Another sort of the investments shows six different domestic equity categories and one international, and seven different categories of hedge funds. Private Equities likewise cover a wide range, both international and domestic.

Since minutes of Investment Committee meetings were not kept prior to May 2002, there is no record of the frequency or depth of manager reviews prior to that time. However, in the six meetings between May '02 and June '03 there was only one meeting (in July '02) in which three managers appeared before the committee along with three prospective managers. Three out of 47 hardly qualifies as responsible oversight. During that same period a number of hedge fund managers were added and several private equity commitments were made with no report of these actions in the minutes.

### 2. Transparency

Hedge funds are among the least transparent investments because they do not provide portfolio details as do managers of publicly traded securities. The Funds of Funds are even less transparent. According to Michelle Chicoine, the largest of these, Preferred Investors (P.I.), does not reveal the names of the hedge funds in which it is invested, making it a blind pool of blind pools. P.I. provides an asset allocation breakdown only. The lack of transparency makes the assessment of the fund managers themselves all the more important. Yet SCA's reports are entirely statistical, leaving those with oversight responsibility in the dark about what - as opposed to how - the managers are doing. There is no way to tell whether the various managers are multiplying risks or whether their positions are working at cross purposes. Among all of the hedge fund investments,

for instance, is the endowment net short or long? By how much? Leverage is restricted, but how much is employed? Of the managers with a mandate to invest on a global basis, what is the school's exposure to overseas markets or non-dollar assets? Where does such important information come together? It is not unusual to navigate by instruments when visibility is poor, but the instruments must tell you what you need to know. Dead reckoning is not appropriate. Presumably there are risk controls on the individual managers, but where is the overall risk control? Certainly such lack of visibility, read information, places a heavy burden on the consultant, the Treasurer, and the members of the Investment Committee to carefully vet and monitor the managers.

### 3. Measurement

Studies have shown that the performance differential between median managers and top quartile managers increases substantially in the move across the investment spectrum from fixed income to equities to hedge funds and private equity. (The less efficient the market, the greater the degree of performance variability among managers.) I find it astonishing that, with all the numbers generated by SCA, there are no peer comparisons, arguably important data: Delegation of investment authority is a long-accepted tenet of the Prudent Man Rule, but the delegator must act responsibly from the best information available. How does an investment manager compare, not just to an index, but to others in the same category with similar objectives? Some of the benchmarks used in SCA's quarterly reports do not seem appropriate. For instance, the CT Fixed Income Fund of Funds has as its benchmark the Lehman Aggregate Bond Index – an interesting comparison (results should compare favorably, otherwise why not buy the index and save the fee?) but it in no way reflects the investment mix or practices of the school's manager. Likewise, the marketable managers are compared to various indices, but not to their peers. Thus the committee lacks the most basic information by which to judge its managers as well as its own success and the value added by SCA in hiring (and firing) managers.

### 4. Costs

Under New Hampshire's Uniform Trustees' Powers Act, RSA 564-A:3b, paragraph VIII(b), a trustee must “. . . incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.” While investment management fees should not be the primary consideration for the Investment Committee, they are not an insignificant factor, even though results are reported appropriately on a “net of fees” basis. The reported fees in the school's audit report are seriously understated. It includes only cash paid out to SCA and to the managers of marketable securities which comprise a small portion of the total endowment. Moreover, the reported 2002 and 2003 totals of \$1.7 million and \$1.1 million are distorted by a UBIT charge in 2002 and a UBIT credit in 2003. Most, if not all, of the hedge fund and private equity managers collect their fees “off the top” of the school's

investment rather than billing the school directly. Applying a 1% average fee as a conservative estimate, total management fees likely exceed \$3 million plus SCA's estimated fee of \$360,000, roughly three times the amount reported in the audit. There is also a cost in having as many managers as the school has in that fee schedules usually decline as the amount under management rises. Funds of Funds add another layer of fees. A 2002 Commonfund Benchmarks Study of 424 institutions with endowments in the \$100 million to \$500 million range reported an average cost of 52 basis points. The school's total cost should be monitored and reported.

##### 5. Alternatives to Alternatives

Proponents of the school's heavy commitment to hedge funds and to private equity make the valid argument that, because the endowment is permanent capital, or close to it, a substantial proportion can be committed to non-marketable investments. Immediate liquidity is not required in that sizable capital draws, particularly on short notice, are unlikely. However, there is a second, more important reason for liquidity, namely for investment flexibility: To be able to adjust strategically the investment mix within the endowment. Most asset classes swing through a broad valuation range over a period of years, creating opportunities for investors willing to adapt. No one can quantify this factor, but it is the main reason that illiquid investments must generate well above-average returns. The question to ask is: Are there marketable alternatives to consider that offer competitive returns without sacrificing liquidity? I have no way of knowing if the question was even raised and debated. (As an aside, this illustrates one of the drawbacks of centering full authority in one individual and the potential benefit of a small, fully engaged group.) My point is not just theoretical: Two sizable, liquid sectors, REITs and fixed-income investments of all stripes, generated highly competitive three- and five-year returns through 12/31/03. The REIT Index generated a 15.1% annual return for the five years ended December 31, and Global Bonds, 8.2%. For the last three years the REIT Index returned 16.6% annually and Global Bonds, 15.1%. In both of these categories a significant portion of the return was in the form of cash (interest and dividend income), something the SPS endowment does not generate net of fees. These returns compare well with the returns on the school's Private Equity and most of its hedge fund managers. The \$28 million invested with Preferred Investors generated three- and five-year returns of 2% and 8.5% respectively (SCA 12/31/03 summary). Since the majority of the managers have been brought in within the past three years, there is no comparable return data for those managers in SCA's reports. The overall endowment return for the past three and five years is 1.6% and 8.4% annualized.

##### Hedge Funds – A Word of Caution

Since hedge funds comprise far and away the largest portion of the school's endowment – 45% as of 12/31/03 with a target allocation of 50% - I would like to offer some

observations. I recognize that the school's hedge funds are clustered in the lower volatility (low standard deviation) end of the spectrum. This includes the asset breakdown of Preferred Investors as of year end with 57% in arbitrage/event-driven funds. The term "absolute return" has a reassuring ring to it, but it is important to recognize that hedge fund operators function in the real world, too. My first point is that because of hedge funds' relatively favorable performance through the recent bear market, they have attracted a huge amount of new capital in the past few years, the same phenomenon that was visited upon the venture capital business in the latter half of the 1990's on the heels of superior performance. In the end too much money chasing far too few opportunities ruined the game for everyone. VC returns collapsed. At the very least the hedge fund business faces a similar problem, not causing returns to collapse necessarily, but certainly pressuring returns. In the past few years the hedge fund business has gone downscale, offering "opportunities" to investors of relatively modest means, a bad sign. There are three other reasons that hedge fund returns in general have been less than stellar in recent years: One relates to interest rates, another to merger and acquisition activity, and a third to picking stocks, both long and short. An important, not well-recognized source of profit for hedge fund managers is the interest earned on the cash received on short sales, known as the short interest rebate. What was a significant profit contributor at 5% or 6% interest rates generates very little at today's 1% rate. The second source of profit comes from the arbitrage in mergers and acquisitions. While M&A activity has picked up recently, the drought in merger and acquisition activity meant less opportunity and narrower spreads. (The largest portion of the school's hedge fund investments is in the event-driven category - \$60 million.) Finally, long-short equity strategies (SPS has four managers with a total of \$23 million) involve stock-picking. In 2002 and 2003 many managers found that their short sales rose more than their longs, i.e., junk outperformed. Presumably these are not permanent changes, but they serve to illustrate that no single strategy is immune from pressures. It pays to keep an open mind. Minutes of recent Investment Committee meetings reflect welcome steps to reduce hedge fund exposure.

If a private investment goes sour, the only early exit is through the secondary market at a steep discount. For example, in Paul Capital Partners VI (a \$10 million commitment made in 1998) several dot-com investments, made early in the life of the fund, evaporated. The result: an estimated 3-4% annual return over the life of the fund. The school has little choice but to sit out the investment no matter what other opportunities might present themselves over the life of that partnership (ten years or more). Hedge funds offer more liquidity than the school's private equity investments, but withdrawals are generally limited to once a year with varying notice requirements.

#### 6. Cash Requirements – For Operations and Private Equity

Cash needed to fund annual transfers to operations under the Spending Policy – 4.8% of a 12-quarter moving average of market value last year – totals \$18 million. Remaining

commitments of \$53.2 million on the school's private equity investments represent a second call on cash, the timing of which is uncertain since it depends upon the pace at which the general partners find and fund investments. Assuming the cash calls stretch over three to five years, the calls might average \$10-\$15 million annually for a combined total cash need each year of roughly \$30 million, 9-10% of the total endowment. Excluding only the 17% locked into private equity, the percentage rises to 11%. The actual private capital drawdown is likely to be less than the reported commitment for two reasons: First, \$11.4 million of the unfunded total is in ventures that are currently listed as harvesting as opposed to the funding mode. Some of these funds could cancel remaining subscriptions as was done by one fund (Venture Investment Associates II) last year. A \$6.1 million commitment has been outstanding for seven years to North American Properties. It seems unlikely to be called at this late stage. Second, private equity distributions will serve to reduce the net amount. (In the second half of calendar 2003 distributions actually exceeded capital calls by \$2.6 million.) Nevertheless, while the total remaining commitments is likely to be well short of the \$53 million reported figure, neither the capital calls nor the distributions are predictable in timing or in amount. That makes planning difficult.

Since the endowment generates no income net of fees, the school has to carry a large cash reserve and/or have the flexibility to raise these substantial required sums by liquidating holdings in a manner that doesn't adversely affect the desired asset mix or future investment returns. Thus key decisions have to be made: Are funds drawn from the best-performing asset class or manager, or the worst? How much lead time is necessary or appropriate? (Hedge funds have controls on the timing and extent of withdrawals.) In a period of high manager turnover, such as the past few years, cash can be set aside in the process of changing managers. Under stable conditions with less turnover, a more proactive policy would be required. I could find no reference to this issue in the Investment Policy Statement or in the Investment Committee meeting minutes. Presumably the Treasurer has been making the decisions, but policy guidelines would be prudent and the decision-making responsibility belongs with the Investment Committee.

Since outstanding commitments are large relative to current private capital investments, capital calls could drive the allocation to private equity well above the targeted level, particularly if distributions lag and appreciation in the balance of the portfolio is modest. In that case the targeted allocation could end up having to chase the actual mix, not guide it.

### Recommendations

Professor Light offers nine "suggestions" at the conclusion of his report. I endorse these and would upgrade them to strong recommendations. My additional recommendations are as follows:

1. The Treasurer should not be granted sole authority over investment matters. I recommend that the school appoint a Treasurer to fulfill the traditional responsibilities of that position, and that Mr. Baker or another trustee be named as Chair of the Investment Committee, charged with responsibility for the endowment. The committee should be small (five to six members) which would obviate the need for an executive committee of the Investment Committee. Given the depth of understanding required of Committee members, it might be helpful to permit a trustee whose normal term has expired to remain a member of the Committee, particularly if trustee terms are reduced.
2. The target allocation in the Board-adopted Investment Policy should be refined as I have suggested, including definitions of the various alternative asset classes, narrower minimum/maximum ranges and a 20% cap on private equity. The cap on hedge funds should be well below the current level.
3. Minutes of Investment Committee meetings should be included in Board of Trustee meeting materials and should detail decisions on changes in asset mix, reallocation of funds among managers and the addition and deletion of managers, along with the normal investment performance reports. Those reports should show not only how the endowment is doing but also how the committee's decisions on asset allocation and manager selection have contributed to the results, i.e. relative to index returns.
4. The Investment Committee should conduct an annual review of the investment consultant and periodically "rehire" as is now more common with auditing firms.
5. The Investment Committee should oversee the preparation of a clear, consistent annual report on the endowment for the St. Paul's community, making sure that the report is fair and accurate. It should emphasize that values assigned to private equity are imprecise and imperfect.
6. The Investment Committee should make a spending rate recommendation to the full Board annually working in concert with the Finance Committee and the CFO. (It is not clear to me that the school is adjusting the 12-quarter moving average for capital withdrawals, not to be confused with the annual transfer to operations, which could lead to inadvertently exceeding the specified spending rate.)

7. According to the SCA reports, the school maintains a 10% total return objective for the portfolio. While the future is unknown, most long-range estimates are measurably lower. Harvard and Yale, even with all their specialized asset classes, use a 6% real return. The Investment Committee should review the current objective. The risk in setting an overly ambitious objective is that it could drive the endowment up the risk curve. Also if the target finds its way into the long-term financial planning model adjustments to future budgets could be painful if results fall short. In addition the 10% objective seems out of synch with the current 4.8% spending rate. The endowment should aim for "generational equity": providing as much support to current operations as reasonable without impinging on the capacity of the endowment to provide the same degree of support to future generations. New capital should be the source of growth of the endowment in real terms.

April 9, 2004

Harold W. Janeway



## Addendum

### Comments on Jay Light's Report

#### I. Asset Allocation

While it is true that the school's reduced focus on traditional marketable investment is consistent with the practices of today's endowment leaders, what is not consistent is the school's unusual focus on hedge funds. Furthermore, there are important asset classes in marketable and private investments that the school has little or no exposure to such as international, both fixed income and equities, emerging markets, real estate, through marketable real estate investment trusts and private pools as well as sub-categories such as distressed debt and secondary private equity. In a sense the focus on hedge funds may have precluded consideration of these other vehicles or they do not fall within the scope of SCA's expertise. It is not accurate to describe St. Paul's asset allocation as similar to the "big boys" with so many of those other parts omitted from the mix.

If hedge funds are indeed to serve as "a higher return version of fixed income," which is a reasonable concept, then they should do so. As noted earlier, the school's record in that regard is not impressive.

As I have indicated in my report, the school's move to reduce its exposure to equities served it well in the recent bear market. However, I question whether the focus on minimizing volatility may be excessive. After all, there is a difference between volatility and outright loss. In permanent funds such as these, particularly with a 12-quarter averaging used for budgeting purposes, the school's operations are reasonably insulated from market value fluctuations. I would not be the first person to observe that consultants have a tendency at times to guide clients into a system that necessitates the continued employment of the consultant and to discourage consideration of solutions in which the consultant has no useful role to perform. The Investment Committee should reach its own conclusion as to whether SCA's patent-pending "powerful client-driven tools" best serve the committee's interests.

#### II. External Managers

I agree with Professor Light's observation that the school's investment fees are not out of line for the sort of program represented by this endowment. We are also in agreement that its greater complexity requires more due diligence and continuous, careful monitoring. The high turnover of managers in recent years is not only costly (it creates friction) but it requires a tremendous amount of time and attention, particularly in light of the relatively small positions of many of the



investments. It is clear from my experience and from the minutes that a small investment can take as much time as one many times larger. An additional point: The very complexity and the size of the hedge fund investments requires that the committee members have substantial competence in that category, something that also applies in the private equity field (the SPS asset mix is not one for your average Investment Committee). The need for this special knowledge embedded in the committee risks crowding out the generalists who may be better positioned with their broader perspective to add value to the deliberations and decisions regarding overall asset allocation. That experience should be an equally important consideration in appointing members to the committee.

### III. The Role of the Business Office

As noted in the body of my report, I agree with Professor Light's suggestions. He suggests (4) that the school's financial staff, specifically the CFO, be involved more deeply in strategic discussions, implementation and performance monitoring. Knowing of the tremendous demands on a school's Business Office and on the Chief Financial Officer, and the specialized nature of endowment investment matters, it is not realistic to expect the school's financial staff to play such a key role even with the addition of David Corey to the staff. I do agree that the endowment records belong in the Business Office.